

SIERRA BANCORP
Form 10-K
March 13, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of registrant as specified in its charter)

California
(State of incorporation)

33-0937517
(I.R.S. Employer Identification Number)
86 North Main Street Porterville, California 93257

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(Address of principal executive offices) (Zip Code)

(559) 782-4900

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, No Par Value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of June 30, 2007, the last business day of Registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates of the Registrant was approximately \$212 million, based on the closing price reported to the Registrant on that date of \$28.20 per share.

Shares of Common Stock held by each officer and director and each person owning more than five percent of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of the affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of Common Stock of the registrant outstanding as of January 31, 2008 was 9,591,088.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2008 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

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PART I

ITEM 1. BUSINESS

General

The Company

Sierra Bancorp (the "Company"), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the "Bank") in August 2001. The Company's principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company's only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). This additional regulatory capital has enabled the Company to add branches and grow assets while maintaining its classification as a well-capitalized institution. Pursuant to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), Sierra Statutory Trust II and Sierra Capital Trust III are not reflected on a consolidated basis in the financial statements of the Company.

The Company's principal source of income is dividends from the Bank, although supplemental sources of income may be explored in the future. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, the cost of servicing debt, legal fees, audit fees, and shareholder costs will generally be paid from dividends paid to the Company by the Bank, and from TRUPS proceeds retained by the Company (i.e., the funds remaining after down-streaming some of the proceeds to the Bank as capital).

At December 31, 2007, the Company had consolidated assets of \$1.2 billion, deposits of \$850 million and shareholders' equity of \$99 million. The Company's liabilities include \$30 million in debt obligations due to Sierra Statutory Trust II and Sierra Capital Trust III, related to TRUPS issued by those entities.

References herein to the "Company" include the Company and its consolidated subsidiary, unless the context indicates otherwise.

The Bank

The Bank is a California state-chartered bank headquartered in Porterville, California. The Bank was incorporated in September 1977 and opened for business in January 1978, and it has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. The Bank is an independent multi-community bank that offers a full range of retail and commercial banking services primarily in the central and southern sections of California's San Joaquin Valley. On the southern end, our footprint extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. We currently operate 21 full service branch offices throughout this geographic footprint, in addition to an internet branch which provides the ability to open deposit accounts online. The Bank's two newest brick and mortar branches commenced operations in Delano in March 2007 and Bakersfield in February 2006. Our next office is expected to be another branch in the city of Bakersfield, with an anticipated opening in the second quarter of 2008. We have also executed a lease for a pre-existing branch building in the Sunnyside area of South Fresno. Renovation activities have commenced, and that branch could be operational as early as Summer 2008. The locations of the Bank's current offices are:

Porterville:	Administrative Headquarters	Main Office	West Olive Branch
	86 North Main Street	90 North Main Street	1498 West Olive Avenue

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Bakersfield:	Bakersfield California Office	Bakersfield Ming Office	Bakersfield Riverlakes Office
	5060 California Avenue	8500 Ming Avenue	4060 Coffee Road
California City:	California City Office		
	8031 California City Blvd.		
Clovis:	Clovis Office		
	1710 Clovis Avenue		
Delano:	Delano Office		
	1126 Main St.		
Dinuba:	Dinuba Office		
	401 East Tulare Street		
Exeter:	Exeter Office		
	1103 West Visalia Road		
Fresno:	Fresno Shaw Office	Fresno Herndon Office	
	636 East Shaw Avenue	7029 N. Ingram Avenue	
Hanford:	Hanford Office		
	427 West Lacey Boulevard		
Lindsay:	Lindsay Office		
	142 South Mirage Avenue		
Reedley:	Reedley Office		
	1095 W. Manning Street		
Tehachapi:	Tehachapi Downtown Office	Tehachapi Old Town Office	
	224 West F Street	21000 Mission Street	
Three Rivers:	Three Rivers Office		
	40884 Sierra Drive		
Tulare:	Tulare Office		
	246 East Tulare Avenue		
Visalia:	Visalia Mooney Office	Visalia Downtown Office	
	2515 South Mooney Blvd.	128 East Main Street	

The Bank's gross loan and lease balances at the end of 2007 totaled \$925 million. The Bank's lending activities are well-diversified and include real estate, commercial (including small business), agricultural, and consumer loans. The bulk of our real estate loans are secured by commercial or professional office properties which are predominantly owner-occupied. In addition, we staff our Fresno, Visalia, Porterville, and Bakersfield offices with real estate lending specialists who are responsible for a complete line of land acquisition and development loans, construction loans for residential and commercial development, and multifamily credit facilities. Secondary market services are provided through the Bank's affiliations with Freddie Mac, Fannie Mae and various non-governmental programs.

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An Agricultural Credit Center located in Porterville provides a complete line of credit services in support of the agricultural activities that are key to the continued economic development of the communities we serve. Ag lending clients include a full range of individual farming customers, small business farming organizations, and major corporate farming units. We also actively engage in Small Business Administration (SBA) lending. We have been designated as an SBA Preferred Lender since 1999, and Bank of the Sierra is a participant in the SBA's innovative Community Express program. Another service we provide to business customers is equipment leasing, including both direct finance and operating leases. Our principal retail lending services include home equity lines, consumer loans, and credit card loans.

As of December 31, 2007, the percentage of our total loan and lease portfolio for each of the principal areas in which we directed our lending activities were as follows: (i) loans secured by real estate (75.3%); (ii) commercial and industrial loans (including SBA loans) (14.9%); (iii) consumer loans (5.9%); (iv) direct finance leases (2.5%); and (v) agricultural production loans (1.4%). Real estate

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loans and related activities generated total revenue of \$58.2 million in 2007 and \$51.9 million in 2006. Interest, fees, and loan sale income on real-estate secured loans totaled approximately 57% of our total interest and other income for 2007 and 56% in 2006.

In addition to loans, we offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts (including money market demand accounts), time deposits, retirement accounts, and sweep accounts (sweep products facilitate more efficient cash management for our business customers, by automatically sweeping idle cash from demand deposit accounts into interest-bearing repos or money market deposit accounts). We attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, convenient locations, and drive-up banking, all provided with the highest level of customer service. At December 31, 2007 we had 69,075 deposit accounts totaling \$850 million, including brokered deposits, compared to 60,788 deposit accounts totaling \$868 million as of December 31, 2006.

We offer a multitude of other products and services to complement our lending and deposit services. These include installment note collection, cashier's checks, traveler's checks, gift cards, bank-by-mail, night depository, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, online banking, ATMs, and other customary banking services. In addition to onsite ATMs at all of our branches, we operate our own offsite ATM's at seven different non-branch locations. We also joined the Allpoint network in 2007, which provides our customers with surcharge-free access to over 32,000 ATMs across the nation, including 3,900 in California. Allpoint ATM locations include National and regional retailers such as Target and Costco. Our conversion to the Pulse EFT network in the fourth quarter of 2007 also provides our customers with access to electronic point-of-sale payment alternatives nationwide. Online banking, including bill-pay functionality, was introduced in late 1999 and has steadily grown in popularity since then, with active users doubling during 2007 to almost 15,000 individual and business customers. In 2007 we added the ability to open deposit accounts online. We also recently implemented remote deposit capture capabilities, to allow our business customers to send their check deposits to us electronically. Furthermore, to ensure that the accessibility preferences of all customers are addressed, we operate a telephone banking system that is accessible 24 hours a day seven days a week, and we have established a convenient customer service group accessible by toll-free telephone.

To provide non-deposit investment options we have a strategic alliance with Investment Centers of America, Inc. of Bismarck, North Dakota (ICA). Through this arrangement, registered and licensed representatives of ICA provide our customers with convenient access to annuities, insurance products, mutual funds, and a full range of investment products. They conduct business from offices located in our Porterville, Visalia, Tulare, and Fresno branches.

We have not engaged in any material research activities related to the development of new products or services during the last two fiscal years. However, our officers and employees are continually searching for ways to increase public convenience, enhance public access to the electronic payments system, and enable us to improve our competitive position. The cost to the Bank for these development, operations, and marketing activities cannot be specifically calculated with any degree of certainty.

We hold no patents or licenses (other than licenses required by appropriate bank regulatory agencies), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural orientation of the Central Valley. As our branches in more metropolitan areas such as Fresno and Bakersfield have expanded, however, the agriculture-related base has become less important. We are not dependent on a single customer or group of related customers for a material portion of our deposits, nor is a material portion of our loans concentrated within a single industry or group of related industries. The amounts expended on compliance with government and regulatory mandates related to anti-terrorism, corporate responsibility, and customer privacy have not been insignificant. However, as far as can be reasonably determined there has been no material effect upon our capital expenditures, earnings, or competitive position as a result of Federal, state, or local environmental regulation.

Recent Developments

On March 15, 2007, the Board of Directors of Bank of the Sierra approved the sale of the Bank's credit card portfolio, consisting of \$8.2 million in consumer card balances and \$2.6 million in commercial loan balances. This decision was reached because of the

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financial benefits of a sale, as well as the expanded credit card options and superior service that the purchaser can provide to our customers. The sale of our credit card portfolio to Elan Financial Services, a wholly owned subsidiary of U.S. Bancorp, took place effective June 1, 2007. It generated a premium on balances sold of about \$1.2 million and enabled us to release the approximate \$400,000 liability we had accrued for the redemption of credit card scorecard points, for a total pre-tax gain of \$1.6 million. The sale also freed up the \$500,000 portion of our loan loss allowance that had been allocated for potential credit card losses. In projecting the impact of the sale on operating income going forward, it should be noted that we will continue to participate in a share of the interchange and interest revenue generated by credit cards issued in our name. Furthermore, we have eliminated most of the costs associated with our credit cards, including funding costs, personnel costs, servicing costs, net loan losses, and the scorecard liability accrual. With the exception of the gain on sale and non-recurring conversion-related costs, the sale-related impact on pre-tax operating income has thus far been immaterial.

In June 2007 the Company entered into new contracts for debit and ATM networks, as well as for processing debit and ATM transactions. The actual conversion took place in mid-November, 2007. Based on growth expectations for debit and ATM transactions and relative to the terms of the previous contracts, the new contracts are expected to enhance the Company's pre-tax income by approximately \$2.9 million over five years, although that amount could ultimately be significantly different than projected. For the 12 month period commencing in mid-November 2007, the total pre-tax income enhancement is expected to be close to \$450,000, of which approximately \$300,000 should be from reduced non-interest expense and the remainder should be in the form of higher non-interest revenue. The new contracts will allow us to enhance customer service by implementing new programs and technologies such as debit rewards, contactless debit cards, and improved fraud detection capabilities.

One adverse event in 2007 was the cessation of our relationship with Genpact, the company that was paying Bank of the Sierra referral fees for consumer mortgage applications which were ultimately approved and funded by them. They provided Bank of the Sierra branded telephone, internet, and branch access channels, allowing us to provide our customers access to home loans without having a mortgage lending division of our own. Genpact unilaterally terminated these arrangements in the summer of 2007, when the subprime debacle caused their funding sources to evaporate. Understanding the importance of a community bank's ability to offer retail mortgage loans to its customers, we have been actively searching for an alternative since then and expect to have new arrangements in place by the second quarter of 2008.

Other developments in 2007 include the implementation of a marketing initiative aimed at increasing consumer checking account balances. This initiative, which includes the formulation of a new deposit account line-up, multiple direct mail campaigns, and extensive training for front-line personnel, added significantly to the Company's operating expense (primarily marketing costs) in 2007 relative to 2006. The training commenced in late 2006, and the initial marketing pieces were mailed and the new account line-up debuted in January 2007. The program was expanded to include commercial deposit accounts in the fourth quarter of 2007.

Recent Accounting Pronouncements

Information on recent accounting pronouncements is contained in Footnote 2 to the Financial Statements.

Competition

The banking business in California in general, and specifically in many of our market areas, is highly competitive with respect to virtually all products and services. The industry continues to consolidate, and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many largely unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to nearly all significant banking services and products. These competitive trends are likely to continue.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined four counties within which the Company operates, including Tulare, Kern, Fresno, and Kings counties, the top six institutions are all multi-billion dollar entities with an aggregate of 164 offices that control 62.5% of deposit market share based on June 30, 2007 FDIC market share data. Bank of the Sierra ranks

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seventh with a 4.8% share of total deposits, up slightly from 4.5% in 2006. In Tulare County, however, where the Bank was originally formed, we rank first for total number of branch locations (9) and second for deposit market share with 17.6% of total deposits, up from 16.7% in 2006 and behind only Bank of America (22.1%). The largest portion of deposits in the combined four-county area also belongs to Bank of America (23.1%), followed by Wells Fargo (13.1%) and Washington Mutual (8.0%). Fremont Investment & Loan, Union Bank of California, and Citibank round out the top six. These banks have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. They can also offer certain services that we do not offer directly but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limit, we typically arrange for the sale, or participation, of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, and investment banking firms. In recent years, we have also witnessed increased competition from specialized companies that offer wholesale finance, credit card, and other consumer finance services, as well as services that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, or other means. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to compete in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. Many customers now expect a choice of delivery channels, including telephone, mail, personal computer, ATMs, self-service branches, and/or in-store branches. These products are offered by traditional banks and savings associations, as well as credit unions, brokerage firms, asset management groups, finance and insurance companies, internet-based companies, and mortgage banking firms.

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have placed additional pressure on other banks within the industry to remain competitive by streamlining operations, reducing expenses, and increasing revenues. Competition has also intensified due to federal and state interstate banking laws enacted in the mid-1990s, which permit banking organizations to expand into other states. The relatively large and expanding California market has been particularly attractive to out-of-state institutions. The Financial Modernization Act, effective March 11, 2000 (see Regulation and Supervision Financial Modernization Act), has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions.

For years we have countered rising competition by offering a broad array of products in an innovative and flexible manner. We are able to offer our customers community-oriented, personalized service that cannot always be matched by the major banks. We rely on local promotional activity, personal contacts by our officers, directors, employees, and shareholders, and individualized service provided through accommodative policies. This approach appears to be well-received by the populace of the San Joaquin Valley, who appreciate a high-touch, customer-oriented environment in which to conduct their financial transactions. Other competitive advantages include our retention of drive-up teller windows, which have been eliminated by much of the competition, and our preferred lender or PLP status with the Small Business Administration, which enables us to approve SBA loans faster than many of our competitors. Layered onto the Company's traditional personal-contact banking philosophy are sophisticated telephone banking, internet banking, and online bill payment capabilities, which were initiated to meet the needs of customers with electronic access requirements and provide automated 24-hour banking. This high-tech and high-touch approach allows individuals to customize access to the Company to their particular preference.

Employees

As of December 31, 2007 the Company had 283 full-time and 112 part-time employees. On a full time equivalent basis, staffing stood at 371 at December 31, 2007 as compared to 361 at December 31, 2006, an increase necessitated mainly by the addition of staff during 2007 for the new Delano office.

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Regulation and Supervision

The Company and the Bank are subject to significant regulation by federal and state regulatory agencies. The following discussion of statutes and regulations is only a brief summary and does not purport to be complete. This discussion is qualified in its entirety by reference to such statutes and regulations. No assurance can be given that such statutes or regulations will not change in the future.

Regulation of the Company Generally

The Company's stock is traded on the NASDAQ Global Select Market under the symbol BSRR, and as such the Company is subject to NASDAQ rules and regulations including those related to corporate governance. The Company is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires the Company to file annual, quarterly and other current reports with the Securities and Exchange Commission (the "SEC"). The Company is subject to additional regulations including, but not limited to, the proxy and tender offer rules promulgated by the SEC under Sections 13 and 14 of the Exchange Act; the reporting requirements of directors, executive officers and principal shareholders regarding transactions in the Company's Common Stock, and short-swing profits rules promulgated by the SEC under Section 16 of the Exchange Act; and certain additional reporting requirements for principal shareholders of the Company promulgated by the SEC under Section 13 of the Exchange Act. As a publicly traded company which had more than \$75 million in public float as of June 30, 2007, the Company is classified as an "accelerated filer." In addition to accelerated time frames for filing SEC periodic reports, this also means that the Company is subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 with regard to documenting, testing, and attesting to internal controls over financial reporting.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956 and is registered as such with the Federal Reserve Board. A bank holding company is required to file with the Federal Reserve Board annual reports and other information regarding its business operations and those of its subsidiaries. It is also subject to periodic examination by the Federal Reserve Board and is required to obtain Federal Reserve Board approval before acquiring, directly or indirectly, ownership of the voting shares of any bank if, after such acquisition, it would directly or indirectly own or control more than 5% of the voting stock of that bank, unless it already owns a majority of the voting stock of that bank.

The Federal Reserve Board has by regulation determined certain activities in which a bank holding company may or may not conduct business. A bank holding company must engage, with certain exceptions, in the business of banking or managing or controlling banks or furnishing services to or performing services for its subsidiary banks. The permissible activities and affiliations of certain bank holding companies were expanded in 2000 by the Financial Modernization Act. (See "Financial Modernization Act" below.)

The Company and the Bank are deemed to be affiliates of each other within the meaning set forth in the Federal Reserve Act and are subject to Sections 23A and 23B of the Federal Reserve Act. This means, for example, that there are limitations on loans by the Bank to affiliates, and that all affiliate transactions must satisfy certain limitations and otherwise be on terms and conditions at least as favorable to the Bank as would be available for non-affiliates.

The Federal Reserve Board has a policy that bank holding companies must serve as a source of financial and managerial strength to their subsidiary banks. It is the Federal Reserve Board's position that bank holding companies should stand ready to use their available resources to provide adequate capital to their subsidiary banks during periods of financial stress or adversity. Bank holding companies should also maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting their subsidiary banks.

The Federal Reserve Board also has the authority to regulate bank holding company debt, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances, the Federal Reserve Board may require the Company to file written notice and obtain its approval prior to purchasing or redeeming the Company's equity securities. The Company's existing stock repurchase program (see "Item 5 - Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities - Stock Repurchases") is not subject to any such notification or approval requirements.

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Regulation of the Bank Generally

As a California state-chartered bank whose accounts are insured by the FDIC, the Bank is subject to regulation, supervision and regular examination by the California Department of Financial Institutions (the DFI) and the FDIC. In addition, while the Bank is not a member of the Federal Reserve System, it is subject to certain regulations of the Federal Reserve Board. The regulations of these agencies govern most aspects of the Bank's business, including the making of periodic reports by the Bank, and the Bank's activities relating to dividends, investments, loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits and numerous other areas. Supervision and examination of the Bank by the FDIC and any legal actions taken by the FDIC with respect thereto are generally intended to protect depositors and are not intended for the protection of shareholders.

The earnings and growth of the Bank are largely dependent on its ability to maintain a favorable differential, or spread, between the yield on its interest-earning assets and the rates paid on its deposits and other interest-bearing liabilities. As a result, the Bank's performance is influenced by general economic conditions, both domestic and foreign, the monetary and fiscal policies of the federal government, and the policies of the regulatory agencies, particularly the Federal Reserve Board. The Federal Reserve Board implements national monetary policies (such as seeking to curb inflation and combat recession) by means of open-market operations in United States Government securities, adjusting the required level of reserves for financial institutions subject to its reserve requirements, and varying the discount rate applicable to borrowings by banks that are members of the Federal Reserve System. The actions of the Federal Reserve Board in these areas influence the growth of bank loans, investments and deposits and also affect interest rates on loans and deposits. The nature and impact of any future changes in monetary policies cannot be predicted.

Capital Adequacy Requirements

The Company and the Bank are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. Each of the federal regulators has established risk-based and leverage capital guidelines for the banks or bank holding companies it regulates, which set total capital requirements and define capital in terms of core capital elements, or Tier 1 capital; and supplemental capital elements, or Tier 2 capital. Tier 1 capital is generally defined as the sum of the core capital elements less goodwill and certain other deductions, notably the unrealized net gains or losses (after tax adjustments) on available for sale investment securities carried at fair market value. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (not to exceed 25% of tier 1 capital plus goodwill); and (iii) minority interests in the equity accounts of consolidated subsidiaries. At December 31, 2007, approximately 24% of the Company's Tier 1 capital consisted of trust preferred securities, however no assurance can be given that trust preferred securities will continue to be treated as Tier 1 capital in the future. Tier 2 capital can include: (i) allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as core capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; and (iv) term subordinated debt and intermediate-term preferred stock and related surplus (but not more than 50% of Tier 1 capital). The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100% of Tier 1 capital, net of goodwill.

The minimum required ratio of qualifying total capital to total risk-weighted assets is 8% (Total Risk-Based Capital Ratio), at least one-half of which must be in the form of Tier 1 capital, and the minimum required ratio of Tier 1 capital to total risk-weighted assets is 4% (Tier 1 Risk-Based Capital Ratio). Risk-based capital ratios are calculated to provide a measure of capital that reflects the degree of risk associated with a financial institution's operations for transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are recorded as off-balance sheet items. Under risk-based capital guidelines, the nominal dollar amounts of assets and credit-equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as unsecured loans. As of December 31, 2007 and 2006, Bank-only Total Risk-Based Capital Ratios were 13.28% and 12.49%, respectively, and the Bank's Tier 1 Risk-Based Capital Ratios were

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12.06% and 11.31%, respectively. As of December 31, 2007 and 2006, the consolidated Company's Total Risk-Based Capital Ratios were 13.33% and 12.98%, respectively, and its Tier 1 Risk-Based Capital Ratios were 12.11% and 11.77%, respectively.

The risk-based capital requirements also take into account concentrations of credit involving collateral or loan type, and the risks of non-traditional activities (those that have not customarily been part of the banking business). The regulations require institutions with high or inordinate levels of risk to operate with higher minimum capital standards, and authorize the regulators to review an institution's management of such risks in assessing an institution's capital adequacy. Additionally, the regulatory Statements of Policy on risk-based capital regulations include exposure to interest rate risk as a factor that the regulators will consider in evaluating a bank's capital adequacy, although interest rate risk does not impact the calculation of a bank's risk-based capital ratios. Interest rate risk is the exposure of a bank's current and future earnings and equity capital to adverse movement in interest rates. While interest risk is inherent in a bank's role as financial intermediary, it introduces volatility to earnings and to the economic value of the bank.

The FDIC and the Federal Reserve Board also require financial institutions to report a leverage ratio, defined as Tier 1 capital (net of all intangibles) to adjusted total assets. Banks and bank holding companies that have received the highest rating of the five categories used by regulators to rate banks and are not anticipating or experiencing any significant growth must maintain a leverage ratio of at least 3%. All other institutions are required to maintain a leverage ratio of at least 4% to 5%. Pursuant to federal regulations, banks must maintain capital levels commensurate with the level of risk to which they are exposed, including the volume and severity of problem loans, and federal regulators may set higher capital requirements when a bank's particular circumstances warrant. Bank-only Leverage Capital Ratios were 10.17% and 9.53% on December 31, 2007 and 2006, respectively. As of December 31, 2007 and 2006, the consolidated Company's leverage capital ratios were 10.22% and 9.92%, respectively. Both the Bank and the Company were well capitalized at December 31, 2007 and 2006.

For more information on the Company's capital, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation - Capital Resources. Risk-based capital ratio requirements are discussed in greater detail in the following section.

Prompt Corrective Action Provisions

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. The federal banking agencies have by regulation defined the following five capital categories: well capitalized (Total Risk-Based Capital Ratio of 10%; Tier 1 Risk-Based Capital Ratio of 6%; and Leverage Ratio of 5%); adequately capitalized (Total Risk-Based Capital Ratio of 8%; Tier 1 Risk-Based Capital Ratio of 4%; and Leverage Ratio of 4%, or 3% if the institution receives the highest rating from its primary regulator); undercapitalized (Total Risk-Based Capital Ratio of less than 8%; Tier 1 Risk-Based Capital Ratio of less than 4%; or Leverage Ratio of less than 4%, or 3% if the institution receives the highest rating from its primary regulator); significantly undercapitalized (Total Risk-Based Capital Ratio of less than 6%; Tier 1 Risk-Based Capital Ratio of less than 3%; or Leverage Ratio less than 3%); and critically undercapitalized (tangible equity to total assets less than 2%). As of December 31, 2007 and 2006, the Bank was deemed to be well capitalized for regulatory capital purposes. A bank may be treated as though it were in the next lower capital category if, after notice and the opportunity for a hearing, the appropriate federal agency finds an unsafe or unsound condition or practice so warrants, but no bank may be treated as critically undercapitalized unless its actual capital ratio warrants such treatment.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions if to do so would make the bank undercapitalized. Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). Significantly undercapitalized banks are subject to broad regulatory authority, including among other things, capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying bonuses or increasing compensation to senior executive officers without FDIC approval. Even more severe

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restrictions apply to critically undercapitalized banks. Most importantly, except under limited circumstances, not later than 90 days after an insured bank becomes critically undercapitalized the appropriate federal banking agency is required to appoint a conservator or receiver for the bank.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the issuance of cease and desist orders, termination of insurance of deposits (in the case of a bank), the imposition of civil money penalties, the issuance of directives to increase capital, formal and informal agreements, or removal and prohibition orders against institution-affiliated parties.

Safety and Soundness Standards

The federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designed to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan and institute enforcement proceedings if an acceptable compliance plan is not submitted.

Premiums for Deposit Insurance

The Bank's deposits are insured under the Federal Deposit Insurance Act up to maximum applicable limits, and are therefore subject to deposit insurance assessments to maintain the FDIC's Deposit Insurance Fund (DIF). The Bank paid no deposit insurance assessments on its deposits under the risk-based assessment system utilized by the FDIC through December 31, 2006. The FDIC adopted a new risk-based insurance assessment system effective January 1, 2007, designed to tie what banks pay for deposit insurance more closely to the risks they pose. The FDIC also adopted a new base schedule of rates that the FDIC can adjust up or down, depending on the needs of the DIF, and set initial premiums that range from \$0.05 per \$100 of domestic deposits in the lowest risk category to \$0.43 per \$100 of domestic deposits for banks in the highest risk category. The new assessment system resulted in annual assessments to the Bank of \$0.05 per \$100 of insurable domestic deposits. An FDIC credit available to the Bank for prior contributions offset the assessments payable in 2007, but is expected to be fully utilized with the assessment payable during the first quarter of 2008.

In addition, banks must continue to pay an amount toward the retirement of the Financing Corporation bonds issued in the 1980's to assist in the recovery of the savings and loan industry. This amount fluctuates, but for the first quarter of 2008 is \$0.0114 per \$100 of insured deposits. These assessments will continue until the Financing Corporation bonds mature in 2017 through 2019.

Community Reinvestment Act

The Bank is subject to certain requirements and reporting obligations under the Community Reinvestment Act (CRA). The CRA generally requires federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods. The CRA further requires the agencies to consider a financial institution's efforts in meeting its community credit needs when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations. In measuring a bank's compliance with its CRA obligations, the regulators utilize a performance-based evaluation system. They determine CRA ratings based on the bank's actual lending, service, and investment activities, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FDIC assigns a rating of outstanding, satisfactory, needs to improve or substantial noncompliance. The Bank was last examined for CRA compliance in August 2007 when it received a satisfactory Assessment Rating.

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Financial Modernization Act

Effective March 11, 2000, the Gramm-Leach-Bliley Act, also known as the Financial Modernization Act, enabled full affiliations to occur among banks and securities firms, insurance companies, and other financial service providers, and enabled full affiliations to occur between such entities. This legislation permits bank holding companies that are well-capitalized, well-managed and meet other conditions to elect to become financial holding companies. As financial holding companies, they and their subsidiaries are permitted to acquire or engage in activities that were not allowed for them as bank holding companies, such as insurance underwriting, securities underwriting and distribution, travel agency activities, broad insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary to these activities. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the Financial Modernization Act applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. The Company has no current intention of becoming a financial holding company, but may do so at some point in the future if deemed appropriate in view of opportunities or circumstances at the time.

Privacy and Data Security

The Financial Modernization Act also imposed new requirements on financial institutions with respect to consumer privacy. The statute generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. Financial institutions, however, will be required to comply with state law if it is more protective of consumer privacy than the Financial Modernization Act. The statute also directed federal regulators, including the Federal Reserve and the FDIC, to prescribe standards for the security of consumer information. The Company and the Bank are subject to such standards, as well as standards for notifying consumers in the event of a security breach.

Other Consumer Protection Laws and Regulations

Activities of all insured banks are subject to a variety of statutes and regulations designed to protect consumers, such as the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Truth-in-Lending Act. Interest and other charges collected or contracted for by the Bank are also subject to state usury laws and certain other federal laws concerning interest rates. The Bank's loan operations are also subject to federal laws and regulations applicable to credit transactions. Together, these laws and regulations include provisions that:

govern disclosures of credit terms to consumer borrowers;

require financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the communities it serves;

prohibit discrimination on the basis of race, creed, or other prohibited factors in extending credit;

govern the use and provision of information to credit reporting agencies; and

govern the manner in which consumer debts may be collected by collection agencies.

The Bank's deposit operations are also subject to laws and regulations that:

impose a duty to maintain the confidentiality of consumer financial records and prescribe procedures for complying with administrative subpoenas of financial records; and

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govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

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Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Banking Act) regulates the interstate activities of banks and bank holding companies. Generally speaking, under the Interstate Banking Act, a bank holding company located in one state may lawfully acquire a bank located in any other state, subject to deposit-percentage, aging requirements and other restrictions. The Interstate Banking Act also generally provides that national and state-chartered banks may, subject to applicable state law, branch interstate through acquisitions of banks in other states. The Interstate Banking Act and related California laws have increased competition in the environment in which the Bank operates to the extent that out-of-state financial institutions directly or indirectly enter the Bank's market areas. It appears that the Interstate Banking Act has contributed to the accelerated consolidation of the banking industry.

USA Patriot Act of 2001

The USA Patriot Act of 2001 (the Patriot Act) was enacted in October 2001 in response to the terrorist attacks in New York, Pennsylvania and Washington, D.C. on September 11, 2001. The Patriot Act was designed to strengthen the ability of U.S. law enforcement agencies and intelligence communities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps to:

conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transactions;

ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The Patriot Act also requires all financial institutions to establish anti-money laundering programs, which must include, at minimum:

the development of internal policies, procedures, and controls;

the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

The Company has incorporated the requirements of the Patriot Act into its operating procedures, and while these requirements have resulted in an additional time burden, the financial impact on the Company is difficult to quantify.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) was enacted to increase corporate responsibility, provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and protect investors by improving the accuracy and reliability of disclosures pursuant to the securities laws. Sarbanes-Oxley includes important new requirements for public companies in the areas of financial disclosure, corporate governance, and the independence, composition and responsibilities of audit committees. Among other things, Sarbanes-Oxley mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and speedier transaction reporting requirements for executive officers, directors and 10% shareholders. In addition, penalties for non-compliance with the Exchange Act were heightened. SEC rules promulgated pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to

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enhance their independence from management, and include extensive additional disclosure, corporate governance and other related rules. Sarbanes-Oxley represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

The Company has not experienced any significant difficulties in complying with Sarbanes-Oxley. However, the Company has incurred, and expects to continue to incur, significant time and expense in connection with its compliance with Section 404 of Sarbanes-Oxley (SOX 404), which requires management to undertake an annual assessment of the adequacy and effectiveness of the Company s internal controls over financial reporting and requires the Company s auditors to attest to, and report on, management s assessment and the operating effectiveness of these controls.

Commercial Real Estate Lending Concentrations

On December 2, 2006, the federal bank regulatory agencies released Guidance on Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk Management Practices (the Guidance). The Guidance, which was issued in response to the agencies concern that rising CRE concentrations might expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the commercial real estate market, reinforces existing regulations and guidelines for real estate lending and loan portfolio management. Highlights of the Guidance include the following:

The agencies have observed that CRE concentrations have been rising over the past several years, with small to mid-size institutions showing the most significant increase over the last decade. However, some institutions risk management practices are not evolving with their increasing CRE concentrations, and therefore, the Guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program.

The Guidance applies to national banks and state chartered banks, and is also broadly applicable to bank holding companies. For purposes of the Guidance, CRE loans include loans for land development and construction, other land loans, and loans secured by multifamily and nonfarm residential properties. The definition also extends to loans to real estate investment trusts and unsecured loans to developers if their performance is closely linked to the performance of the general CRE market.

The agencies recognize that banks serve a vital role in their communities by supplying credit for business and real estate development. Therefore, the Guidance is not intended to limit banks CRE lending. Instead, the Guidance encourages institutions to identify and monitor credit concentrations, establish internal concentration limits, and report concentrations to management and the board of directors on a periodic basis.

The agencies recognized that different types of CRE lending present different levels of risk, and therefore, institutions are encouraged to segment their CRE portfolios to acknowledge these distinctions. However, the CRE portfolio should not be divided into multiple sections simply to avoid the appearance of risk concentration.

Institutions should address the following key elements in establishing a risk management framework for identifying, monitoring, and controlling CRE risk: (1) board of directors and management oversight; (2) portfolio management; (3) management information systems; (4) market analysis; (5) credit underwriting standards; (6) portfolio stress testing and sensitivity analysis; and (7) credit review function.

As part of the ongoing supervisory monitoring processes, the agencies will use certain criteria to identify institutions that are potentially exposed to significant CRE concentration risk. An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds specified supervisory guidelines may be identified for further supervisory analysis.

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The Company has a concentration in CRE loans, and thus believes that the Guidance is applicable to it. The Company and its board of directors have discussed the Guidance and believe that that the Company's underwriting policy, management information systems, independent credit administration process and monthly monitoring of real estate loan concentrations will be sufficient to address the Guidance.

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Allowance for Loan and Lease Losses

On December 13, 2006, the federal bank regulatory agencies released Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL), which revises and replaces the banking agencies' 1993 policy statement on the ALLL. The revised statement was issued to ensure consistency with generally accepted accounting principles (GAAP) and more recent supervisory guidance. The agencies also issued 16 FAQs to assist institutions in complying with both GAAP and ALLL supervisory guidance. Highlights of the revised statement include the following:

The revised statement emphasizes that the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports, and that an assessment of the appropriateness of the ALLL is critical to an institution's safety and soundness.

Each institution has a responsibility to develop, maintain, and document a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL. An institution must maintain an ALLL that is sufficient to cover estimated credit losses on individual impaired loans as well as estimated credit losses inherent in the remainder of the portfolio.

The revised statement updates the previous guidance on the following issues regarding ALLL: (1) responsibilities of the board of directors, management, and bank examiners; (2) factors to be considered in the estimation of ALLL; and (3) objectives and elements of an effective loan review system.

The Company and its board of directors have discussed the revised statement and believe that the Company's ALLL methodology is comprehensive, systematic, and that it is consistently applied across the Company. The Company believes its management information systems, independent credit administration process, policies and procedures are sufficient to address the guidance.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Company, the Bank and the banking industry in general are pending, and additional initiatives may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject the Bank to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Company or the Bank would be affected thereby.

ITEM 1A. RISK FACTORS

Statements and financial discussion and analysis by management contained throughout this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve a number of risks and uncertainties. Factors that could cause actual results to differ materially from forward-looking statements herein include, without limitation, the factors set forth below.

Poor economic conditions in our market areas could hurt our business materially. A substantial majority of our assets and deposits are generated in the San Joaquin Valley in central California. As a result, poor economic conditions in this region could cause us to incur losses associated with higher default rates and decreased collateral values in our loan portfolio.

Current national and local economic indicators point toward the strong possibility of recession, although neither the severity nor the duration of a slump in economic activity can be projected with any degree of accuracy. The economic decline has already contributed to a significant increase in the Company's non-performing assets. If the decline develops into a recession, the strong growth experienced in the south and central San Joaquin Valley in recent years would likely come to a temporary halt. That growth has occurred for a number of reasons. The area's relatively inexpensive real estate and central proximity to both Southern and Northern California have attracted a growing number of warehouse and distribution facilities, as well as manufacturing, health, and other service companies. The low cost of housing has also drawn retirees from more expensive areas of California. Despite the economic growth that has occurred, unemployment levels have been relatively high in the San Joaquin Valley. In Tulare County, for example,

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which is our geographic center and the base of our agriculturally oriented communities, the unemployment rate was 10.9% in December 2007, almost double the 6.1% aggregate unemployment rate for California for the same month. The unemployment rate for Tulare County has been improving, however, dropping to an average of 9% for 2007 and 2006 from 10% in 2005, almost 12% for 2001 through 2004, and nearly 16% for 1990 through 2000. A slowdown in construction and economic activity has the potential to reverse this favorable trend.

Conditions which have a negative impact on the agricultural industry could have an adverse effect on our customers and their ability to make payments to us. While the current spike up in the Company's non-performing assets is comprised mainly of loans secured by residential and commercial real estate, much of our large increases in years past have been the direct consequence of persistent agricultural difficulties. This is due to the fact that a sizable portion of our total loan portfolio consists of loans to borrowers either directly or indirectly involved in the agricultural industry. While a great number of our borrowers may not be individually involved in agriculture, many of the jobs in the San Joaquin Valley are ancillary to the regular production, processing, marketing and sales of agricultural commodities.

Global competition is another significant issue affecting the agricultural industry. Because of increased global competition and other factors, excess supply and low prices currently characterize the markets for many agricultural products. The ripple effect of lower commodity prices for milk, nuts, olives, grapes, oranges and tree fruit has a tendency to depress land prices, lower borrower income, and decrease collateral values. A degenerative cycle of weather and commodity prices can also impact consumer purchasing power, which has the potential to create further unemployment throughout the San Joaquin Valley. Weather patterns in particular are of critical importance to row crop, tree fruit, and orange production. By way of example, the recent freeze in the San Joaquin Valley destroyed much of the orange crop as well as various other goods. Many large growers, packing houses, and transportation companies carry insurance to help offset the detrimental impact of the freeze, and were able to continue operations with minimal financial disruption. Many small-acreage farmers, however, do not have insurance coverage and encountered severe economic difficulties. Likewise, the laborers involved in picking and packing typically do not have backup resources when employment prospects disappear, and are forced to rely on donations and government assistance rather than patronize the retail outlets that they otherwise might. It should be noted that the recent freeze in and of itself did not have a noticeable impact on our operations, but if general agricultural conditions do not improve our level of non-performing assets could increase. Such conditions have affected and may continue to adversely affect our borrowers and, by extension, our business.

Concentrations of real estate loans could subject us to increased risks in the event of a real estate recession or natural disaster. Our loan portfolio is heavily concentrated in real estate loans, particularly commercial real estate. At December 31, 2007, 75% of our loan portfolio consisted of loans secured by real estate. Balances secured by commercial properties and construction and development loans represent \$457 million of this amount, while loans secured by residential properties and loans secured by farmland represent \$187 million and \$52 million, respectively.

Total non-performing assets increased \$8.9 million during 2007, ending the year at \$9.6 million relative to only \$689,000 at December 31, 2006. Nearly \$7 million of the increase was in loans secured by commercial properties and construction and development loans. Non-accruing residential real estate loans increased by \$666,000, and foreclosed assets were \$556,000 higher. Non-performing assets represented 1.04% and 0.08% of total gross loans and other real estate owned at December 31, 2007 and 2006, respectively. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Nonperforming Assets, for a detailed discussion of this increase.

The Central Valley residential real estate market experienced declining prices and a slower sales pace during 2007. If residential real estate values and sales continue to slide, and/or if this weakness flows over into commercial real estate, the Company's nonperforming assets could increase further. Such an increase could have a material impact on our financial condition and results of operations, by reducing our income, increasing our expenses, and leaving less cash available for lending and other activities. As noted above, the primary collateral for many of our loans consists of commercial real estate properties, and deterioration in the real estate market in the areas the Company serves would likely reduce the value of the collateral value for many of our loans and could negatively impact the repayment ability of many of our borrowers. It might also reduce the amount of loans the Company makes

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to businesses in the construction and real estate industry, which could negatively impact our organic growth prospects. Similarly, the occurrence of a natural disaster like those California has experienced in the past, including earthquakes, brush fires, and flooding, could impair the value of the collateral we hold for real estate secured loans and negatively impact our results of operations.

In addition, the banking regulators are now giving commercial real estate loans greater scrutiny, due to perceived risks relating to the cyclical nature of the real estate market and the related risks for lenders with high concentrations of such loans. The regulators may require banks with higher levels of CRE loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, and might require higher levels of allowances for possible loan losses and capital levels as a result of CRE lending growth and exposures. See Regulation and Supervision Commercial Real Estate Lending Concentrations above.

We may experience loan and lease losses in excess of our allowance for loan and lease losses. We are careful in our loan underwriting process in order to limit the risk that borrowers might fail to repay; nevertheless, losses can and do occur. We create an allowance for estimated loan and lease losses in our accounting records, based on estimates of the following:

industry standards;

historical experience with our loans;

evaluation of economic conditions;

regular reviews of the quality mix and size of the overall loan portfolio;

a detailed cash flow analysis for non-performing loans;

regular reviews of delinquencies; and

the quality of the collateral underlying our loans.

We maintain an allowance for loan and lease losses at a level that we believe is adequate to absorb any specifically identified losses as well as any other losses inherent in our loan portfolio. However, changes in economic, operating and other conditions, including changes in interest rates, that are beyond our control, may cause our actual loan losses to exceed our current allowance estimates. If actual losses exceed the amount reserved, it will have a negative impact on our profitability. In addition, the FDIC and the DFI, as part of their supervisory functions, periodically review our allowance for loan and lease losses. Such agencies may require us to increase our provision for loan and lease losses or to recognize further losses, based on their judgments, which may be different from those of our management. Any increase in the allowance required by the FDIC or the DFI could also hurt our business.

We may not be able to continue to attract and retain banking customers at current levels, and our efforts to compete may reduce our profitability. Competition in the banking industry in the markets we serve may limit our ability to continue to attract and retain banking customers. The banking business in our current and intended future market areas is highly competitive with respect to virtually all products and services. In California generally, and in our service areas specifically, branches of major banks dominate the commercial banking industry. Such banks have substantially greater lending limits than we have, offer certain services we cannot offer directly, and often operate with economies of scale that result in lower operating costs than ours on a per loan or per asset basis. We also compete with numerous financial and quasi-financial institutions for deposits and loans, including providers of financial services over the Internet. Ultimately, competition can and does increase our cost of funds, reduce loan yields and drive down our net interest margin, thereby reducing profitability. It can also make it more difficult for us to continue to increase the size of our loan portfolio and deposit base, and could cause us to rely more heavily on borrowings, which are generally more expensive than deposits. See Item 1, Business Competition.

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Our earnings are subject to interest rate risk, especially if rates rise. Banking companies' earnings depend largely on the relationship between the cost of funds, primarily deposits and borrowings, and the yield on earning assets, such as loans and investment securities. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by the monetary policies of the Federal Reserve Board and the international interest rate environment, as well as by economic, regulatory and competitive factors which influence interest rates, the volume and mix of interest earning assets and interest bearing liabilities, and the level of nonperforming assets. Many of these factors are beyond our control. We are subject to interest rate risk to the degree that our interest bearing liabilities reprice or mature more slowly or more rapidly or on a different basis than our interest earning assets. Fluctuations in interest rates also affect the demand of customers for our products and services.

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Given the current volume, mix, and re-pricing characteristics of the Company's interest earning assets and interest bearing liabilities, our interest rate spread is expected to decrease slightly in a rising rate environment but should remain relatively stable in declining interest rate scenarios. However, there are scenarios where fluctuations in interest rates in either direction could have a negative effect on net income. For example, if funding rates rise faster than asset yields in a rising rate environment (i.e., if basis compression occurs), or if we do not actively manage certain loan index rates in a declining rate environment, we could be negatively impacted. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Market Risk Management—Interest Rate Risk Management.

We may have difficulty managing our growth. Management intends to leverage the Company's current infrastructure to grow assets, and the addition of new branches has been tentatively planned. Our ability to manage growth will depend primarily on our ability to:

monitor and manage expanded operations;

control funding costs and operating expenses;

maintain positive customer relations; and

attract, assimilate and retain qualified personnel.

If we fail to achieve these objectives in an efficient and timely manner we may experience disruptions in our business plans, and our financial condition and results of operations could be adversely affected.

You may not be able to sell your shares at the times and in the amounts you want if the trading market for our stock does not remain active. Although our stock has been listed on NASDAQ for many years, trading in our stock does not consistently occur in high volumes and cannot always be characterized as amounting to an active trading market.

We depend on our executive officers and key personnel to implement our business strategy and could be harmed by the loss of their services. We believe that our continued growth and success depends in large part upon the skills of our management team. The competition for qualified personnel in the financial services industry is intense, and the loss of our key personnel or an inability to continue to attract, retain or motivate key personnel could adversely affect our business. If we are not able to retain our existing key personnel or to attract additional qualified personnel, our business operations would be hurt. Our President/Chief Executive Officer has been with us since the Bank's inception in 1977. He became fully vested in his retirement benefits upon reaching the age of 66, but he does not currently have any plans for immediate retirement. Our Executive Vice President/Chief Credit Officer and our Executive Vice President/Chief Financial Officer joined us in 2005 and 2001, respectively. Our Executive Vice President/Chief Banking Officer joined the Bank in 2001 and was promoted to his current position in 2006. None of our executive officers have employment agreements.

Our directors and executive officers control a large amount of our stock, and your interests may not always be the same as those of the board and management. As of December 31, 2007, our directors and executive officers together with their affiliates beneficially owned approximately 22% of the Company's outstanding voting stock (not including vested option shares). As a result, if all of these shareholders were to take a common position, they would be able to significantly affect the election of directors as well as the outcome of most corporate actions requiring shareholder approval, such as the approval of mergers or other business combinations. Such concentration may also have the effect of delaying or preventing a change in control of our company.

In some situations, the interests of our directors and executive officers may be different from the shareholders. However, our board of directors and executive officers have a fiduciary duty to act in the best interest of the shareholders, rather than in their own best interests, when considering a proposed business combination or any of these types of matters.

Provisions in our articles of incorporation will delay or prevent changes in control of our corporation or our management. These provisions make it more difficult for another company to acquire us, which could reduce the market price of our common stock and the price that you receive if you sell your shares in the future. These provisions include the following:

staggered terms of office for members of the board of directors;

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no cumulative voting in the election of directors; and

the requirement that our Board of Directors consider the potential social and economic effects on our employees, depositors, customers and the communities we serve as well as certain other factors, when evaluating a possible tender offer, merger or other acquisition of the Company.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

The Company's administrative headquarters is located at 86 North Main Street, Porterville, California, and is leased through April 2014 from parties unrelated to the Company. It consists of approximately 37,000 square feet in a three-story building of which the Company is sole occupant, and the rent as of December 31, 2007 was \$12,478 per month. The Company's main office is adjacent to its administrative headquarters, at 90 N. Main Street, Porterville, California, and consists of a one-story brick building that sits upon unencumbered property owned by the Company. The Company also owns unencumbered property on which 12 of its 20 other branches are located, including the branches in Lindsay, Exeter, Three Rivers, Dinuba, Tulare, Hanford, Tehachapi, and California City. One of the Fresno branches is owned while the other is leased from unrelated parties, and two of the three branches in Bakersfield are leased from unrelated parties. Both Visalia branches and the Clovis branch are leased from unrelated parties, as is our Delano branch. In addition, the Company operates a technology center in Porterville which consists of approximately 12,000 square feet in a freestanding single-story building that is leased from unrelated parties. The Bank has six remote ATM locations leased from unrelated parties, although the amount of monthly rent at these locations is minimal. Management believes that the Company's existing back office facilities are adequate to accommodate the Company's operations for the immediately foreseeable future, although limited branch expansion is planned.

ITEM 3. LEGAL PROCEEDINGS

From time to time, the Company is a party to claims and legal proceedings arising in the ordinary course of business. After taking into consideration information furnished by counsel to the Company as to the current status of these claims or proceedings to which the Company is a party, management is of the opinion that the ultimate aggregate liability represented thereby, if any, will not have a material adverse affect on the financial condition of the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Market Information

Sierra Bancorp's Common Stock trades on the NASDAQ Global Select Market under the symbol BSRR, and the CUSIP number for our stock is #82620P102. Trading in the Common Stock of the Company has not been extensive and such trades cannot be characterized as amounting to an active trading market. Management is aware of the following securities dealers which make a

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market in the Company's stock: Citadel Derivatives Group LLC, Chicago; Citigroup Global Markets, New York; Goldman, Sachs & Co., New York; Howe Barnes Hoefler & Arnett, Inc., San Francisco; Keefe, Bruyette & Woods, New York; Knight Securities, Jersey City; Lehman Brothers Inc., New York; Morgan Stanley, New York; Sandler O'Neill, New York; and UBS Capital Markets, Jersey City. The following table summarizes trades of the Company's Common Stock, setting forth the approximate high and low sales prices and volume of trading for the periods indicated, based upon information provided by public sources.

Calendar Quarter Ended	Sale Price of the Company's Common Stock (per share)		Approximate Trading Volume In Shares
	High	Low	
March 31, 2006	\$ 26.50	\$ 22.16	358,168
June 30, 2006	\$ 28.50	\$ 23.41	723,417
September 30, 2006	\$ 33.37	\$ 25.55	1,102,252
December 31, 2006	\$ 35.36	\$ 29.01	1,136,008
March 31, 2007	\$ 30.67	\$ 26.85	940,717
June 30, 2007	\$ 28.62	\$ 26.60	1,179,854
September 30, 2007	\$ 32.31	\$ 25.41	1,628,595
December 31, 2007	\$ 32.09	\$ 24.13	2,329,706

(b) Holders

On February 29, 2008 there were approximately 2,627 shareholders of the Company's Common Stock. Per the Company's stock transfer agent there were 651 registered holders of record on that date, and there were approximately 1,976 beneficial holders whose shares are held under a street name.

(c) Dividends

The Company paid cash dividends totaling \$6.0 million, or \$0.62 per share in 2007, and \$5.3 million, or \$0.54 per share in 2006, representing 31% of prior year earnings for dividends paid in 2007 and 33% in 2006. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to its growth capacity. However, no assurance can be given that earnings and/or growth expectations in any given year will justify the payment of such a dividend.

As a bank holding company that currently has no significant assets other than its equity interest in the Bank, the Company's ability to declare dividends depends primarily upon dividends it receives from the Bank. The Bank's dividend practices in turn depend upon the Bank's earnings, financial position, current and anticipated capital requirements, and other factors deemed relevant by the Bank's Board of Directors at that time. The power of the Bank's Board of Directors to declare cash dividends is also subject to statutory and regulatory restrictions. Under California banking law, the Bank may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three years (reduced by dividends paid during such period) or, with the prior approval of the California Commissioner of Financial Institutions, in an amount not exceeding the greatest of (i) the retained earnings of the Bank, (ii) the net income of the Bank for its last fiscal year, or (iii) the net income of the Bank for its current fiscal year. The payment of any cash dividends by the Bank will depend not only upon the Bank's earnings during a specified period, but also on the Bank meeting certain regulatory capital requirements.

The Company's ability to pay dividends is also limited by state corporation law. The California General Corporation Law allows a California corporation to pay dividends if the company's retained earnings equal at least the amount of the proposed dividend. If a California corporation does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if it meets two conditions immediately after giving effect to the dividend, but it is extremely unlikely that those conditions would ever be met by the Company. In addition, during any period in which the Company has deferred payment of interest otherwise due and payable on its subordinated debt securities, it may not make any dividends or distributions with respect to its capital stock (see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital Resources).

Table of Contents**(d) Securities Authorized for Issuance under Equity Compensation Plans**

The following table provides information as of December 31, 2007, with respect to options outstanding and available under our 2007 Stock Incentive Plan and the now-terminated 1998 Stock Option Plan, which are our only equity compensation plans other than an employee benefit plan meeting the qualification requirements of Section 401(a) of the Internal Revenue Code:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders	750,321	\$ 14.61	1,423,100

(e) Performance Graph

The following is a performance graph comparing the total cumulative shareholder return on the Company's common stock since December 31, 2002 to the cumulative total returns of the NASDAQ Composite Index (a broad equity market index), the SNL Bank Index, and the SNL \$1 billion to \$5 billion (asset size) Bank Index (the latter two qualifying as peer bank indices), assuming a \$100 investment on December 31, 2002 and reinvestment of dividends:

<i>Index</i>	<i>Period Ending</i>					
	<i>12/31/02</i>	<i>12/31/03</i>	<i>12/31/04</i>	<i>12/31/05</i>	<i>12/31/06</i>	<i>12/31/07</i>
Sierra Bancorp	100.00	159.35	237.40	241.40	316.84	274.88
NASDAQ Composite	100.00	150.01	162.89	165.13	180.85	198.60
SNL Bank \$1B-\$5B Index	100.00	135.99	167.83	164.97	190.90	139.06
SNL Bank Index	100.00	134.90	151.17	153.23	179.24	139.28

Table of Contents**(f) Stock Repurchases**

The Company has a stock repurchase program that became effective July 1, 2003 and currently has no expiration date. The plan initially allowed for the repurchase of up to 250,000 shares, although that number was supplemented by an additional 250,000 shares by the Company's Board at its regular meeting in May 2005, another 250,000 shares in March 2006, and 500,000 shares in April 2007. The following table provides information concerning the Company's repurchases of its Common Stock during the fourth quarter of 2007, which were all executed in accordance with SEC Rule 10b-18:

	October	November	December
Total shares purchased	11,053	109,599	46,379
Average per share price	\$ 29.04	\$ 25.69	\$ 25.10
Number of shares purchased as part of publicly announced plan or program	11,053	109,599	46,379
Maximum number of shares remaining for purchase under a plan or program	346,047	236,448	190,069

ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected historical financial information concerning the Company, which should be read in conjunction with our audited consolidated financial statements, including the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations, included elsewhere herein. The selected financial data as of December 31, 2007 and 2006, and for each of the years in the three year period ended December 31, 2007, is derived from our audited consolidated financial statements and related notes which are included in this Annual Report. The selected financial data for prior years is derived from our audited financial statements which are not included in this Annual Report. Throughout this Annual Report, information is for the consolidated Company unless otherwise stated.

Table of Contents**Selected Financial Data**

(Dollars in thousands, except per share data)	As of and for the years ended December 31,				
	2007	2006	2005	2004	2003
Income Statement Summary					
Interest income	\$ 87,551	\$ 80,778	\$ 64,135	\$ 52,008	\$ 42,607
Interest expense	\$ 31,435	\$ 25,131	\$ 13,332	\$ 8,496	\$ 6,874
Net interest income before provision for loan losses	\$ 56,116	\$ 55,647	\$ 50,803	\$ 43,512	\$ 35,733
Provision for loan losses	\$ 3,252	\$ 3,851	\$ 3,150	\$ 3,473	\$ 3,105
Non interest income	\$ 14,900	\$ 11,212	\$ 9,258	\$ 9,792	\$ 9,862
Non-interest expense	\$ 35,981	\$ 33,841	\$ 32,634	\$ 29,311	\$ 27,743
Income before provision for income taxes	\$ 31,783	\$ 29,167	\$ 24,277	\$ 20,520	\$ 14,747
Provision for income taxes	\$ 10,761	\$ 9,977	\$ 8,083	\$ 7,174	\$ 4,383
Net Income	\$ 21,022	\$ 19,190	\$ 16,194	\$ 13,346	\$ 10,364
Balance Sheet Summary					
Total loans, net	\$ 909,312	\$ 872,811	\$ 729,780	\$ 686,157	\$ 602,264
Allowance for loan losses	\$ (12,276)	\$ (11,579)	\$ (9,930)	\$ (8,842)	\$ (6,701)
Securities available for sale	\$ 184,917	\$ 190,272	\$ 193,676	\$ 198,024	\$ 84,798
Cash and due from banks	\$ 44,022	\$ 52,675	\$ 50,147	\$ 36,735	\$ 53,042
Federal funds sold	\$	\$ 6,340	\$	\$	\$
Other foreclosed assets	\$ 556	\$	\$ 533	\$ 2,524	\$ 2,784
Premises and equipment, net	\$ 18,255	\$ 17,978	\$ 18,055	\$ 17,731	\$ 18,291
Total Interest-Earning assets	\$ 1,109,600	\$ 1,084,748	\$ 935,381	\$ 894,835	\$ 696,255
Total Assets	\$ 1,233,735	\$ 1,215,074	\$ 1,052,686	\$ 997,483	\$ 801,674
Total Interest-Bearing liabilities	\$ 874,393	\$ 827,752	\$ 678,009	\$ 680,886	\$ 536,811
Total Deposits	\$ 850,147	\$ 868,445	\$ 815,671	\$ 742,703	\$ 684,477
Total Liabilities	\$ 1,134,271	\$ 1,124,703	\$ 973,923	\$ 926,348	\$ 741,698
Total Shareholders Equity	\$ 99,464	\$ 90,371	\$ 78,763	\$ 71,135	\$ 59,976
Per Share Data					
Net Income Per Basic Share	\$ 2.17	\$ 1.96	\$ 1.66	\$ 1.41	\$ 1.12
Net Income Per Diluted Share	\$ 2.09	\$ 1.87	\$ 1.56	\$ 1.31	\$ 1.03
Book Value	\$ 10.39	\$ 9.27	\$ 8.10	\$ 7.37	\$ 6.43
Cash Dividends	\$ 0.62	\$ 0.54	\$ 0.45	\$ 0.37	\$ 0.36
Weighted Average Common Shares Outstanding Basic	9,700,048	9,766,729	9,763,896	9,482,201	9,288,908
Weighted Average Common Shares Outstanding Diluted	10,044,915	10,273,859	10,357,795	10,166,302	10,018,096
Key Operating Ratios:					
Performance Ratios:					
Return on Average Equity ⁽¹⁾	22.28%	22.75%	21.47%	20.50%	18.34%
Return on Average Assets ⁽²⁾	1.74%	1.70%	1.59%	1.47%	1.43%
Net Interest Spread (tax-equivalent) ⁽³⁾	4.43%	4.75%	5.11%	5.17%	5.38%
Net Interest Margin (tax-equivalent)	5.25%	5.58%	5.64%	5.49%	5.71%
Dividend Payout Ratio ⁽⁴⁾	28.64%	27.53%	27.18%	26.27%	32.27%
Equity to Assets Ratio ⁽⁵⁾	7.79%	7.46%	7.40%	7.19%	7.77%
Efficiency Ratio (tax-equivalent)	49.36%	49.63%	52.64%	54.04%	59.66%
Net Loans to Total Deposits at Period End	106.96%	100.50%	89.47%	92.39%	87.99%
Asset Quality Ratios:					
Non Performing Loans to Total Loans	0.98%	0.08%	0.04%	0.35%	1.09%
Nonperforming Assets to Total Loans and Other Real Estate Owned	1.04%	0.08%	0.11%	0.71%	1.54%

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Net Charge-offs (recoveries) to Average Loans	0.28%	0.19%	0.38%	0.21%	0.43%
Allowance for Loan Losses to Net Loans at Period End	1.35%	1.33%	1.36%	1.29%	1.11%
Allowance for Loan Losses to Non-Performing Loans	135.62%	1680.55%	3213.59%	361.19%	100.27%
Capital Ratios:					
Tier 1 Capital to Adjusted Total Assets	10.22%	9.92%	9.87%	9.20%	8.87%
Tier 1 Capital to Total Risk-weighted Assets	12.11%	11.77%	12.01%	11.34%	9.90%
Total Capital to Total Risk-weighted Assets	13.33%	12.98%	13.50%	13.30%	10.88%

- (1) Net income divided by average shareholders' equity.
- (2) Net income divided by average total assets.
- (3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.
- (4) Dividends declared per share divided by net income per share.
- (5) Average equity divided by average total assets.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion presents Management's analysis of the financial condition of the Company as of December 31, 2007 and December 31, 2006, and the results of operations for each of the years in the three-year period ended December 31, 2007. The discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the Notes related thereto presented elsewhere in this Form 10-K Annual Report (see Item 8 below).

Statements contained in this report or incorporated by reference that are not purely historical are forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 as amended, including the Company's expectations, intentions, beliefs, or strategies regarding the future. All forward-looking statements concerning economic conditions, growth rates, income, expenses, or other values as may be included in this document are based on information available to the Company on the date noted, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could materially differ from those in such forward-looking statements. Risk factors that could cause actual results to differ materially from those in forward-looking statements include but are not limited to those outlined previously in Item 1A.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under different conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan losses, as explained in detail in the Provision for Loan Losses and Allowance for Loan Losses sections of this discussion and analysis; deferred loan origination costs, which are estimated pursuant to an annual evaluation of expenses (primarily salaries) associated with successful loan originations and are allocated in like amount to each new loan based on loan type, but can actually vary significantly for individual loans depending on the characteristics of such loans (deferred amounts are disclosed below in conjunction with salaries expense, under Non-interest Revenue and Operating Expense); income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the Provision for Income Taxes and Other Assets sections of this discussion and analysis; goodwill, which is evaluated annually based on changes in the market capitalization of the Company and for which management has determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in footnote 2 (Significant Accounting Policies) to the financial statements contained herein, under the caption Stock-Based Compensation. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.

Summary of Performance

The Company has increased net income in 24 of the last 25 years. Net income in 2007 was \$21.0 million, an increase of \$1.8 million, or 10%, over the \$19.2 million in net earnings achieved in 2006. Net income in 2006 was \$3.0 million higher than 2005 net earnings of \$16.2 million. Net income per basic share was \$2.17 for 2007, as compared to \$1.96 in 2006 and \$1.66 in 2005. The Company's Return on Average Assets was 1.74% and Return on Average Equity was 22.28% in 2007, as compared to 1.70% and 22.75%, respectively for 2006, and 1.59% and 21.47%, respectively in 2005.

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The following are major factors impacting the Company's results of operations in recent years:

While the increase in net interest income was minimal in 2007, solid growth in net interest income made a major contribution to higher net income in 2006. Average interest-earning assets were 7% higher in 2007 than in 2006, but the lift in net interest income that was created by higher earning assets was almost completely offset by net interest margin compression, thus net interest income increased by less than 1%. Our net interest margin was 33 basis points lower in 2007 than in 2006, primarily because average non-interest bearing deposits were \$21 million lower, and because our cost of interest-bearing liabilities was negatively impacted by market interest rate fluctuations, a shift to higher-cost deposits, and a more competitive market for deposits. In contrast to the relatively weak growth in 2007, net interest income grew by \$4.8 million, or 10%, in 2006 relative to 2005. That increase was largely driven by growth in average interest-earning assets, which increased by \$103 million, or 11%, in 2006 compared to 2005. The favorable effect of this growth on net interest income in 2006 was offset in part by the impact of interest rate changes and relatively lackluster core deposit growth.

Our provision for loan losses was \$599,000 lower in 2007 than in 2006, a decline of 16%, but was \$701,000 higher in 2006 than in 2005, representing an increase of 22%. A significant increase in non-performing assets and a higher level of charge-offs are factors that might lead to expectations of a higher loan loss provision in 2007. The provision actually declined in 2007, however, due to the sale of our credit card portfolio and release of the associated loan loss allowance, significantly slower growth in loans, and a higher level of recoveries in 2007. The increase in 2006 was the result of the \$147 million increase in gross outstanding loan balances during 2006, as well as an increased allocation for certain classified loans.

Non-interest income increased by \$3.7 million, or 33%, in 2007 relative to 2006, and by \$2.0 million, or 21%, in 2006 compared to 2005. The most significant factor in the Company's profit improvement in 2007 is service charges on deposits, which increased by \$1.7 million, or 29%, relative to 2006. The increase is primarily attributable to 19% net growth in the number of transaction accounts during 2007. A one-time gain on the sale of our credit card portfolio in the second quarter of 2007 also had a major impact on the Company's financial results, causing loan sale income to increase by over \$1.5 million in 2007 relative to 2006. The increase in non-interest income in 2006 relative to 2005 is due in part to the impact of non-recurring items, but comes mainly from strong increases in service charges on deposits, check card interchange fees, and operating lease income.

Operating expense increased by \$2.1 million, or 6%, in 2007 in comparison to 2006, and by \$1.2 million, or 4%, in 2006 over 2005. Salaries and benefits accounted for more than half of the 2007 increase in operating expense, rising by \$1.1 million, or 7%, mainly because of normal annual salary adjustments and staffing costs associated with our new Delano branch. Occupancy expense actually dropped slightly for 2007 due to lower depreciation expense on furniture, fixtures and equipment, and a reduction in property taxes stemming from one-time refunds received in 2007. Non-interest expenses comprising the Other line item under Other operating expense on our consolidated statements of income were a combined \$1.1 million higher in 2007 than in 2006, an increase of 10%. Much of that increase was in marketing expense, which was up by over 68% due to deposit-focused initiatives put in place at the beginning of 2007. Several non-recurring items totaling over \$600,000 also affected the Other category, as explained below in detail under Non-interest Revenue and Operating Expense. For 2006, the increase in salaries and benefits comprises almost the entire increase in total operating expense relative to 2005. The \$1.1 million, or 7%, increase in salaries and benefits in 2006 includes \$314,000 in stock option expense for which recognition was not required in previous years.

The following summarizes additional key information relating to our current financial condition:

Total assets increased by only \$19 million, or 2%, during 2007. Gross loans and leases increased by \$37 million for the year, an increase of 4% due primarily to organic growth in real-estate loans and commercial loans and leases. Loan growth for the year was negatively impacted by the sale of our credit card portfolio in June 2007. Prior to the sale, we had close to \$3 million in business credit card balances that were included in commercial loans and over \$8 million in consumer credit card balances. The net increase in loans was partially offset by a drop of \$9 million, or 16%, in cash and due from banks; a drop of \$5 million, or 3%, in investment securities; and a decline of over \$6 million in fed funds sold, which fell to zero. The lower balance of cash

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and due from banks is the result of a reduction in cash items in process of collection, while the drop in investment securities is due to prepayments and maturing balances.

Non-performing assets increased by almost \$9 million during 2007, ending the year at \$9.6 million. Foreclosed assets represent \$556,000 of the balance at December 31, 2007. The remaining \$9.1 million of the year-end 2007 non-performing balance is in the form of non-accruing loans, with \$7.6 million of that balance secured by real estate and \$895,000 guaranteed by the U.S. Government. Specific reserves have been allocated for all non-accruing loans based on a detailed analysis of expected cash flows for each loan, and all non-performing and substandard assets are being actively managed.

Total deposits declined by \$18 million, or 2%, in 2007, inclusive of a \$25 million drop in wholesale-sourced brokered deposits. We experienced a difficult year for deposits in 2007, with branch-generated deposits increasing by only \$7 million and lower-cost deposits migrating into higher-cost deposits. Core deposits actually declined by \$6 million over the course of the year. A positive development during 2007 was a net increase of close to 7,000 transaction accounts, which contributed to the rise in non-interest income.

Total non-deposit borrowings grew by \$28 million in 2007, increasing to 24% of total liabilities at the end of 2007 from 21% at the end of 2006. Federal Home Loan Bank (FHLB) borrowings were used to replace maturing brokered deposits in the fourth quarter of 2007 because of a change in pricing dynamics, and were also used to fund that portion of annual asset growth not covered by the increase in branch deposits. Our net loans to total deposits ratio rose to 107% at the end of 2007 from 101% at the end of 2006 due to the runoff of brokered deposits and the increase in wholesale funding. Despite this development, we feel that we still have ample sources of liquidity to fund expected loan growth even if anticipated retail deposit increases don't materialize.

Results of Operations

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expense consists of operating costs that relate to providing a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

Net interest income was \$56.1 million in 2007, compared to \$55.6 million in 2006 and \$50.8 million in 2005. This represents an increase of 1% in 2007 over 2006, and an increase of 10% in 2006 over 2005. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities.

The following Distribution, Rate and Yield table shows, for each of the past three years, the annual average balance for each principal balance sheet category, and the amount of interest income or interest expense associated with that category. This table also shows the yields earned on each component of the Company's investment and loan portfolio, the average rates paid on each segment of the Company's interest bearing liabilities, and the Company's net interest margin.

Table of Contents**Distribution, Rate & Yield**

(dollars in thousands)	Year Ended December 31,								
	2007(a)			2006(a)			2005(a)		
	Average Balance	Income/Expense	Average Rate ^(b)	Average Balance	Income/Expense	Average Rate ^(b)	Average Balance	Income/Expense	Average Rate ^(b)
Assets									
Investments:									
Federal Funds Sold/Due from Time	\$ 1,032	\$ 51	4.94%	\$ 765	\$ 34	4.44%	\$ 4,314	\$ 136	3.15%
Taxable	\$ 131,888	\$ 6,072	4.60%	\$ 141,747	\$ 6,294	4.44%	\$ 164,490	\$ 6,526	3.97%
Non-taxable	\$ 55,305	\$ 2,230	6.20%	\$ 50,941	\$ 2,040	6.16%	\$ 37,526	\$ 1,507	6.08%
Total Investments	\$ 188,225	\$ 8,353	5.08%	\$ 193,453	\$ 8,368	4.89%	\$ 206,330	\$ 8,169	4.34%
Loans and Leases:^(c)									
Agricultural	\$ 11,339	\$ 929	8.19%	\$ 10,950	\$ 932	8.51%	\$ 11,257	\$ 1,471	13.07%
Commercial	\$ 138,193	\$ 12,875	9.32%	\$ 136,946	\$ 12,886	9.41%	\$ 123,351	\$ 9,646	7.82%
Real Estate	\$ 674,793	\$ 58,166	8.62%	\$ 600,047	\$ 51,839	8.64%	\$ 506,991	\$ 39,514	7.79%
Consumer	\$ 55,935	\$ 5,719	10.22%	\$ 53,790	\$ 5,115	9.51%	\$ 50,506	\$ 4,144	8.20%
Consumer Credit Cards	\$ 3,511	\$ 384	10.94%	\$ 8,819	\$ 829	9.40%	\$ 8,414	\$ 851	10.11%
Direct Financing Leases	\$ 17,883	\$ 1,125	6.29%	\$ 13,110	\$ 809	6.17%	\$ 5,020	\$ 340	6.77%
Other	\$ 1,392	\$	0.00%	\$ 379	\$	0.00%	\$ 2,463	\$	0.00%
Total Loans and Leases	\$ 903,046	\$ 79,198	8.77%	\$ 824,041	\$ 72,410	8.79%	\$ 708,002	\$ 55,966	7.90%
Total Interest-Earning Assets ^(e)	\$ 1,091,271	\$ 87,551	8.13%	\$ 1,017,494	\$ 80,778	8.05%	\$ 914,332	\$ 64,135	7.10%
Other Earning Assets	\$ 8,432			\$ 7,823			\$ 6,188		
Non-Earning Assets	\$ 111,399			\$ 105,979			\$ 98,213		
Total Assets	\$ 1,211,102			\$ 1,131,296			\$ 1,018,733		
Liabilities and Shareholders									
Equity									
Interest-Bearing Deposits:									
NOW	\$ 77,880	\$ 302	0.39%	\$ 65,234	\$ 69	0.11%	\$ 68,502	\$ 63	0.09%
Savings	\$ 56,840	\$ 298	0.52%	\$ 68,133	\$ 358	0.53%	\$ 72,903	\$ 383	0.53%
Money Market	\$ 136,609	\$ 4,078	2.99%	\$ 125,344	\$ 2,947	2.35%	\$ 114,171	\$ 821	0.72%
TDOA s, and IRA s	\$ 24,123	\$ 913	3.78%	\$ 23,399	\$ 780	3.33%	\$ 22,267	\$ 481	2.16%
Certificates of Deposit < \$100,000	\$ 120,540	\$ 5,343	4.43%	\$ 96,050	\$ 3,595	3.74%	\$ 86,734	\$ 2,155	2.48%
Certificates of Deposit ≥ \$100,000	\$ 222,483	\$ 10,795	4.85%	\$ 182,380	\$ 8,059	4.42%	\$ 159,579	\$ 4,781	3.00%
Total Int.-Bearing Deposits	\$ 638,475	\$ 21,729	3.40%	\$ 560,540	\$ 15,808	2.82%	\$ 524,156	\$ 8,684	1.66%
Borrowed Funds:									
Federal Funds Purchased	\$ 19,211	\$ 1,019	5.30%	\$ 13,235	\$ 675	5.10%	\$ 690	\$ 28	4.06%
Repurchase Agreements	\$ 24,070	\$ 169	0.70%	\$ 24,281	\$ 161	0.66%	\$ 28,772	\$ 110	0.38%
Short Term Borrowings	\$ 127,115	\$ 5,888	4.63%	\$ 92,106	\$ 4,307	4.68%	\$ 25,357	\$ 824	3.25%
Long Term Borrowings	\$ 10,907	\$ 350	3.21%	\$ 32,674	\$ 975	2.98%	\$ 60,564	\$ 1,501	2.48%
TRUPS	\$ 30,928	\$ 2,280	7.37%	\$ 38,385	\$ 3,205	8.35%	\$ 31,013	\$ 2,185	7.05%
Total Borrowed Funds	\$ 212,231	\$ 9,706	4.57%	\$ 200,681	\$ 9,323	4.65%	\$ 146,396	\$ 4,648	3.17%

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Total Int.-Bearing Liabilities	\$ 850,706	\$ 31,435	3.70%	\$ 761,221	\$ 25,131	3.30%	\$ 670,552	\$ 13,332	1.99%
Demand Deposits	\$ 249,103			\$ 270,183			\$ 260,661		
Other Liabilities	\$ 16,954			\$ 15,530			\$ 12,089		
Shareholders Equity	\$ 94,339			\$ 84,362			\$ 75,431		

Total Liab. and Shareholders

Equity	\$ 1,211,102			\$ 1,131,296			\$ 1,018,733		
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